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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions Between Carriers and Their Nonregulated Affiliates	)	CC Docket No. 93-251

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Comments

of

The Southern New England Telephone Company

The Southern New England Telephone Company (SNET), pursuant to the Federal Communications Commission's (Commission's) Notice of Proposed Rulemaking released October 20, 1993,[1] hereby files its Comments in the above captioned proceeding.

I. Introduction.

The Commission's affiliate transaction rules, in concert with all the other safeguards the Commission requires, are working very well. The Notice's proposals would require local exchange carriers (LECs) to adhere to even more stringent, administratively difficult and contentious rules, procedures and valuation requirements than are in place today, and are a step backward from incentive

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List A B C D E

1 Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions Between Carriers and Their Nonregulated Affiliates, CC Docket No. 93-251, Notice of Proposed Rulemaking released October 20, 1993, FCC 93-453 (Notice).

regulation for LECs. The proposed rules and procedures are *not* the "more simplified regulatory scheme" advocated by Reed Hundt, the Commission's new Chairman.[2]

I. New Affiliate Transaction Rules Are Not Needed.

The Commission proposes major changes to its affiliate transaction rules "to keep carriers from imposing the costs of nonregulated activities on interstate ratepayers, and to keep ratepayers from being harmed by carrier imprudence."[3] No supporting rationale exists, however, for these proposals; the mere statements that "cost-based valuation may not produce reasonable results in all circumstances,"[4] and that prevailing company pricing is "unjustifiable except in limited circumstances,"[5] are conclusory without any evidentiary underpinnings of any sort.

No evidence suggests that consumers have been or will be harmed under the present rules, or how carriers have been imprudent. For example, no one has identified either the number of transactions or the levels of dollars which may have had to be reclassified out of regulation, or how much consumers may have overpaid since the current rules were put in place. There is no evidence that the independent auditor requirements or attest audits have been ineffective, or that the Commission's own review of auditor workpapers has uncovered overcharges to consumers, or that LECs have acted imprudently. New rules, especially the very complex, costly and contentious ones proposed, should not be adopted without a documented or demonstrated need. No such documentation or demonstration has been made.

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2 "New FCC Chief Signals Change," Communications Week, December 6, 1993, pg. 1, at pg. 86 (emphasis added).

3 Notice, para. 1.

4 Notice, para. 11.

5 Notice, para. 15.

A look at another regulated industry is instructive. The electric utility industry, which is larger than the LEC industry,[6] is not subject to such detailed, complex, and burdensome affiliate transaction rules. The Federal Energy Regulatory Commission's (FERC's) rules regarding the transactions between electric company affiliates, are simple and straightforward.[7] There is no demonstrated need to single out local exchange carriers' affiliate transactions with regressive rules that do not apply to other industries in the federal jurisdiction. SNET urges the Commission, as the federal agency with oversight responsibility for an industry like the electric industry (which is similarly facing competition with co-generation and is diversifying with unregulated activities), not to adopt its complex, costly and, in the end, counter-productive proposals.

The Commission's proposed rules surely are not required because, as the Commission itself has correctly stated, price cap regulation serves as a strong deterrent to unlawful cross-subsidization by severing the direct connection between costs and prices.[8] In fact, the Commission adopted price caps (and SNET elected price caps) in order to promote cost efficiencies and benefits to consumers. The Commission has often and firmly stated that its price cap plan promotes cost

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6 The telecommunications service industry's annual revenues (which include non-LEC service providers) in 1992 were $198.5 billion, compared to the electric utility industry's annual revenues of $183.4 billion. The Value Line Investment Survey, Edition 5, October 15, 1993, pgs. 746, 701. The Local Exchange Carrier industry's annual revenues would be much lower, because Value Line's "telecommunications service industry" annual revenues above include non-LEC service providers such as AT&T, Comsat, MCI, McCaw Cellular, and U.S. Cellular.

7 *"Transactions With Associated Companies (Major Utility).* Each utility shall keep its accounts and records so as to be able to furnish accurately and expeditiously statements of all transactions with associated companies. The statements may be required to show the general nature of the transactions, the amounts involved therein and the amounts included in each account prescribed herein with respect to such transactions. Transactions with associated companies shall be recorded in the appropriate accounts for transactions of the same nature. Nothing herein contained, however, shall be construed as restraining the utility from subdividing accounts for the purpose of recording separately transactions with associated companies." 18 C.F.R., Ch. I, Pt. 101, Uniform System of Accounts Prescribed for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act, para. 14.

8 Computer III Remand Proceedings: Bell Operation Company Safeguards and Tier I Local Exchange Company Safeguards, CC Docket No. 90-623, Report and Order released December 20, 1991, FCC 91-381, 6 FCC Rcd 7571 (1991) (CI III R&O), para. 55.

reductions and rewards carriers for increased productivity. In the Report and Order adopting further strengthened regulatory safeguards, the Commission stated:

> We also determine that the adoption of price cap regulation for the LECs constitutes an effective compliment to cost allocation, reporting, and enforcement safeguards, to reduce BOC incentives to cross-subsidize.[9]

Because this is true, LECs are motivated ***not*** to increase regulated costs through affiliate transactions. There is no way -- short of very low returns and, even then, subject to keen regulatory and public scrutiny of subsequent applications to increase rates -- to recover the increased costs with higher rates.[10]

SNET strongly opposes the adoption of the proposed rules because they undercut the very incentives price cap regulation was created to foster. Moreover, no evidence exists to suggest, much less demonstrate, that the additional restrictions are in the public interest.

II. The Commission's Current Rules Are Working Well.

The current Part 32 and 64 rules are effective in preventing LECs from imposing nonregulated costs on ratepayers. These rules were established after lengthy and detailed proceedings, and they were confirmed upon reconsideration and affirmed by the court.[11]

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9 CI III R&O, para. 13 (citation omitted).

10 If the Commission is concerned about any perverse motivations that LECs have to manipulate price cap earnings with affiliate transactions, SNET suggests that the sharing mechanism be eliminated; LECs will then be motivated only to meet and exceed the productivity target with cost efficiencies and growth in regulated telecommunications services.

11 Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, CC Docket No. 86-111, Report and Order, 2 FCC Rcd 1298 (1987); recon. 2 FCC Rcd 6283 (1987); further recon. 3 FCC Rcd 6701 (1988); aff'd. sub nom., Southwestern Bell Corp. v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

The Commission's existing monitoring and enforcement policies and rules have detected infractions, and the Commission has levied penalties.[12] These penalties are significant deterrents to future improper conduct, and indicate to the industry that the Commission takes its affiliate transaction rules and its related enforcement responsibilities very seriously. These cases demonstrate that the Commission is able to detect infringements and will enforce any infractions of its affiliate transactions rules. Carriers are taking, and indeed must take, the rules seriously; LECs are following them properly, and are not overcharging ratepayers.

Subsequent to the detection of infractions, the Commission strengthened its rules even further. The Commission ordered the adoption of a "comprehensive set of strengthened nonstructural safeguards against cross-subsidization."[13] The Commission also ordered additional uniformity in the LECs' cost allocation manuals, "in order for us to provide more effective oversight."[14] The Accounting and Audits Division also strengthened and augmented the independent audit process by requiring that each LEC's independent auditors annually provide "specific information and results of their CAM audit testing on spreadsheets designed by the Accounting and Audits Division."[15] These additional protections and safeguards

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[12] See, New York Telephone Co. and New England Telephone and Telegraph Co., Apparent Violations of the Commission's rules and Policies Governing Transactions with Affiliates, Order to Show Cause and Notice of Apparent Liability for Forfeitures, FCC 90-57, released February 8, 1990, 5 FCC Rcd 866, 870-871 (supporting enforcement actions and the efficacy of the affiliate transaction rules). See also, Contel Telephone Operation Companies Apparent Violation of the Commission's Rules and Policies Governing Transactions with Affiliates, Notice of Apparent Liability and Forfeiture, FCC 91-91, released March 29, 1991, 6 FCC Rcd 1880 (1991).

[13] CI III R&O, para. 11 (emphasis added); see also paras. 9, 46, 98.

[14] Implementation of Further Cost Allocation Uniformity, AAD 92-42, Memorandum Opinion and Order released July 1, 1993, DA 93-765, 8 FCC Rcd 4664 (1993), para. 6 (emphasis added).

[15] See Letter of Kenneth P. Moran, Chief, Accounting and Audits Division, to Eugene J. Baldrate, Director, Federal Regulatory Matters, Southern New England Telephone Company, March 5, 1993, pg. 1 (fourteen spreadsheets attached). See further, Letter of Jose'-Luis Rodriguez, Chief, Audits Branch, To All CAM Filers And Independent Auditors, April 29, 1993.

adequately protect consumers, as demonstrated by the cessation of further violations or notices of apparent liabilities. The current rules are working very well.

Additional evidence supports the conclusion that changes are not needed. While the Commission states that the proposed rules are necessary to "prevent unreasonably high interstate costs" that apparently result from "transactions provided by carriers and those of their nonregulated affiliates that have serving carriers and other affiliates as a primary purpose,"[16] none of SNET's corporate affiliates (other than the holding company) has as its primary purpose "serving the carrier and its affiliates." It is unequivocally the case that SNET's affiliate transactions do not produce unreasonable interstate costs, as has been consistently demonstrated by all its Joint Cost Reports (ARMIS 43-03), by all its independent audits, and by all its CAM filings and updates.[17]

SNET also notes that its tariff rates for interstate access have always been thoroughly reviewed by the Commission and the public, with only minor technical adjustments in the price cap rates resulting. In fact, SNET has reduced its interstate price cap rates by a total of $30 million since electing price cap regulation effective July 1, 1991.

The conclusion must be that the existing scheme is working well, and that consumers are not being harmed by the current safeguards. The Commission's proposals would solve a problem that does not exist.

III. No Universal Percentage Can Be Prescribed.

The Commission proposes that, in order to "curtail sharply"[18] the current rules' reliance on prevailing company pricing, it will "continue to allow prevailing

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[16] Notice, para. 42.

[17] SNET notes here that no member of the public has filed comments objecting to SNET's CAM updates for its last ten filings.

[18] Notice, para. 15.

company pricing only for affiliate transactions in which the nonregulated affiliate sells at least 75% of its output to nonaffiliates."[19]

SNET strongly believes that the prescription of any single percentage of output for all LECs, all their corporate structures, and all their relationships with affiliates would be not only arbitrary, but basically unworkable. Each LEC corporate structure is unique, and responds to individual corporate objectives, market conditions, and many other factors too numerous to elaborate here. Each LEC's affiliates provide products and services that differ from those provided by other LECs' affiliates. Some LECs' affiliates may have many transactions at low values, or a few transactions at high values, with a high percentage, or a low percentage, of transactions or sales with the regulated entity. It would be arbitrary, unfair, and in disregard of reality to prescribe a single percentage as the one and only gauge for "output" to nonaffiliates for every LEC, across all affiliates. Simply, one size does not fit all.

Moreover, no documentation or rationale exists for the proposal of 75%. This threshold is arbitrary, without substantiation, and disregards the industry's wide variety of affiliates and their transactions.

Most importantly, in instances where the threshold was not attained, the determination of fair market value would be very costly. In the hypothetical example where, as a result of an affiliate's "output" being less than the proposed 75% threshold, a LEC would have to perform, or have performed, market analyses to determine the fair market values of the related products and services in a competitive marketplace (assuming that comparable products and services were available in the first place). SNET's preliminary analyses estimate that on average it could cost SNET about $40,000 for each study to determine "fair market value."[20]

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19 See, Notice, paras. 15-22 (emphasis added).

20 Given the brief comment period on this proceeding, it was not possible to obtain more precise estimates of market research costs for SNET's affiliate transactions not meeting the threshold.

If SNET had 60 types of affiliate transactions for which "fair market value" had to be determined, SNET would have to spend approximately $2,400,000 to determine the "fair market values" of those transactions. These new costs produce no additional consumer benefits or better protection for ratepayers than the current rules. The additional costs would actually inhibit the efficient processing and recording of affiliate transactions, and could penalize ratepayers, as the costs would not otherwise be incurred. The proposed rules are therefore not in the public interest.

As an alternative to the prescription of an exact, inflexible, industry-wide threshold applicable to every single situation, SNET proposes that each LEC identify the threshold percentages that would apply to its own affiliate transactions, and which would meet the "sufficiently large number of cases" standard.[21] Each LEC would determine for itself -- to be tested and validated by its independent auditors -- the percentage thresholds which would be adequate to meet the "sufficiently large" standard. These documented and auditable thresholds would respond to each LEC's unique corporate structure and markets, would be described in the auditor's workpapers, and reviewed by the Commission's auditing staff. In this way, each LEC incurs market study costs only when it is prudent to do so, thereby continuing the efficiency incentives the Commission has properly put in place and which have been operating well for some time.

IV. Conclusion.

The Commission's proposed rules on affiliate transactions are contrary to the intent of price cap incentive regulation, and move away from a simplified regulatory scheme. No need for such stringent proposals has been shown. To the contrary, the evidence demonstrates that the current rules work very well. SNET accordingly

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21 See, e.g., Rochester Telephone Corporation's Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs, Memorandum Opinion and Order, AAD 7-1691, DA 89-573, released May 31, 1989, 4 FCC Rcd 4567 (1989), at para. 6.

urges the Commission not to adopt its proposed rules, as they are unnecessary, counterproductive, and, ultimately, contrary to the public interest.

Respectfully submitted,

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